California State Senate Banking, Finance & Insurance Committee

INFORMATIONAL HEARING ON HOMEOWNERSHIP PRESERVATION IN TODAY'S MORTGAGE MARKET

8/21/07

Testimony of Jeffrey Davidson Schrager,
Team Leader, No Homeowner Left Behind (Central Valley),
and President, Realty Blue, Inc.

Chairman Machado and Members of the Committee, I am excited and honored to have been invited to speak today. On behalf of myself, as the lead developer, and the numerous other individuals and organizations that have partnered together in support of our local Foreclosure Prevention Initiative in Fresno called No Homeowner Left Behind, some of whom are here and most of whom are not, please let me thank you for your interest and for the opportunity to share with you what we are doing in the Valley about this problem which affects us all in some way or another.

My name is Jeffrey Davidson Schrager and I am a California Licensed Real Estate broker and President of Realty Blue, Inc in Fresno. I am currently Vice-President of the Community Housing Council of Fresno, a non-profit organization which promotes sustainable homeownership in Fresno County.

As a real estate broker I am on the frontlines and deal with foreclosure in general practice daily in Fresno. According to recent Realtytrac.com data, Fresno is the #14 Metro Area nationwide for foreclosures with nearly 1 in 60 households in default presently. Foreclosures in our area touch all socio-economic groups and cross all geographic boundaries. The rate of defaults in Fresno also continues to rise with 1461 Notices of Default filed in just the last quarter alone according to the most recent numbers I have.

Please let me also emphasize and reiterate the statistic earlier presented that 50% of all homeowners who lose their homes to foreclosure never even contact their lender! We are attempting to change that. Let me explain,

No Homeowner Left Behind began nearly a year ago through discussions I had with Rollie Smith, the Central Valley Regional Director for HUD in Fresno. We wanted to overcome some of the major barriers that at-risk homeowners and resource providers like myself face when dealing with the complex process of foreclosure. Namely:

- Lack of access to information
- Lack of knowledge of available resources by homeowners and resource providers alike
- Poor connections between the available resources and finally,
- Lack of a collective community-based response

We convened meetings with local Non-Profit Organizations such as the Community Housing Council of Fresno, Local Lenders, Realtors®, HUD-Approved Counseling Agencies such as

ByDesign Financial Solutions, as well as local government agencies and representatives, credit counselors, attorneys, tax professionals, consumer advocates, and crisis counselors.

From these meetings we identified:

- What was working in other areas of the country (so as to not "re-invent the wheel")
- What our present resources and capacities were to respond
- Resource areas in which we were lacking
- What our methodology to provide services and referrals to at-risk homeowners would be to get the best possible outcomes for at-risk homeowners immediately

Our goal, and in fact the mission of No Homeowner Left Behind, is to ensure that homeowners have access to timely, accurate, unbiased information and reputable professionals to help them preserve home ownership when feasible, and to minimize loss of equity and other adverse impacts when retention of homeownership is not possible.

This model is somewhat unique in that it uses resource providers as a central point of client contact and referral that enables these professionals to educate and encourage clients to immediately connect with their lenders and other resources providers and *to remain connected to those resources through to a potentially successful outcome.*

Our strategy is comprehensive and includes 3 focus areas: **Prevention**, **Intervention**, and **Impact Mitigation**

(NOTE: Handouts provided to the Committee include the NHLB Strategic Timeline & Network Model)

Our process typically includes these steps: educating resource providers on resources and products available, consumer outreach and contact, developing an action plan, referral to resources such as the HOPE hotline, follow-up, as well as tracking and reporting outcomes.

What's working NOW? Well, I am happy to report:

- We are engaging local industry professionals to participate – We have trained approximately 40 volunteer resource providers so far.
- We are engaging and have the support of local media
- We are a community-based effort which includes the following outreach vectors:
    - Our website www.nohomeownerleftbehind.org
    - Our local hotline
    - Local outreach events

  In fact, our local hotline took 369 calls in June and July combined and is presently staffed by a total of 11 English and Spanish speaking volunteers 24/7, and our recent outreach event in June, attended and supported in part by Wells Fargo, Countrywide Home Loans, and Citimortgage, resulted in 3 known lender workouts (that we know of so far) out of 56 tracked at-risk homeowner attendees!

- Lastly, our model is working right now as a proof of concept and provides a possible exportable tool to others areas of the state.

What's NOT working? Well, we continue to struggle with:

- Difficulties in contacting the appropriate decision makers in the Loan Servicing or Loss Mitigation Departments
- Lack of Capacity of:
    - Knowledgeable Resource Providers
    - Local One-on-One Loss Mitigation Counseling
    - The ability to respond to the unfortunate elder abuse and fraud issues that we come in contact with
- Lack of Funding:
    - For local infrastructure to provide services by local resource providers
    - For possible "Reinstatement" or "Default Cure" products
- Lack of Viable Strategies and Refinance Products to deal with:
    - "No-equity" situations
    - Predatory lending situations
    - Situations where delinquency or defaults have occurred that limit refinance options

Finally, in addition to providing services immediately to at-risk homeowners, our model is a simple but effective, low-cost, and high-impact one that can be exported to other areas and readily implemented on a local level to gain better outcomes for those at-risk.

Let me leave you with three takeaways:

- First, let me emphasize that collectively we are providing services NOW *locally*, but we need funding for our program partners immediately.
- Secondly, one of our model's biggest strengths is the increased awareness by at-risk homeowners and resource providers of other resources available to them and the enhancement of the collaboration between those resources.
- Lastly, and to me possibly the biggest immediate benefit of our model to the at-risk homeowners, is the peace of mind and feeling of being back in control that comes from understanding the foreclosure process better and being aware of potentially new options that they can act upon to help themselves now.

Thank you.

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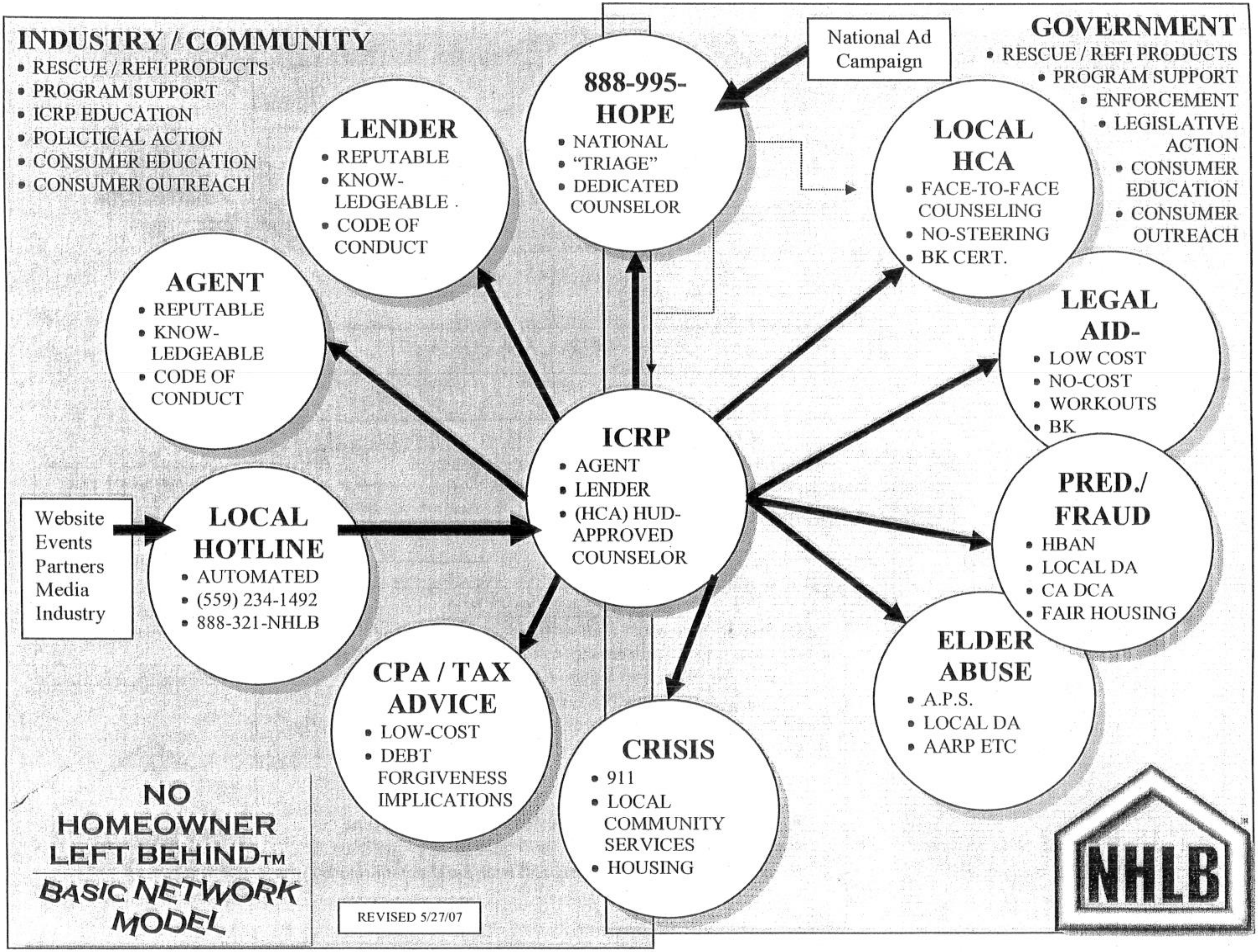
Chair and Committee Member questions followed.



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NHLB

PREVENTION

CREDIT AND FAMILY IMPACT MITIGATION

INTERVENTION

LATE PMT PERIOD
30-60+ DAYS

DEFAULT NOTICE FILED
90 DAY PERIOD MIN.

TRUSTEE SALE FILED
21 DAY PERIOD MIN.

[redacted]

EDUCATION

- Homeowner
- Resource Providers

LEGAL AID CONSULT

COUNSELING (3 R's)

- **R**ECONNECT with Homeowner and re-focus on the problem
- **R**ECAST debts, payment plans, budgets and even loans
- **R**EVISIT and monitor homeowner's progress

COUNSELING

- Credit
- Emotional Support
- Housing Relocation and assistance

SAFETY NET

- Homeowner counseling/notice agreement in Loan Docs if 30 + days Late
- Early Notice of Lates from Lenders
- 800# HOTLINE

INTERVENTION (3 R's)

Note: Due to time constraints of the default process and market conditions, it may be necessary to identify intervention strategy early for maximum value and probability of success.
Example: Reinstate the Loan and then Refinance, or if Reselling is an option or a goal, place home on the market early to maximize possible sales price while potentially working on a reinstatement leading to refinance.

- **R**EINSTATE loan to cure default and/or gain time
- **R**EFINANCE loans into more manageable products
- **R**ESELL home if desired and time and demand exists

NO HOMEOWNER LEFT BEHIND™
STRATEGIC TIMELINE

NHLB™

Martha Lucey's Comments to:
Informational Hearing of the Senate Banking, Finance & insurance Committee on
Preserving the American Dream:
Homeownership Preservation and the Subprime Mortgage Crisis
Tuesday, August 21, 2007

Good afternoon Chairman Machado and committee members. My name is Martha Lucey. I am the President of ByDesign Financial Solutions, a non-profit organization that provides credit counseling, housing counseling, and financial education. ByDesign has twelve offices throughout central California, including offices in Sacramento, Stockton, Fresno and Los Angeles.

ByDesign has offices in three of the top five markets for the highest foreclosure activity in the nation in the first six months of 2007 (www.realtytrack.com). ByDesign has been deluged by homeowners who are currently having trouble making their mortgage payments or who are anticipating having trouble in the near future.

Many of these homeowners did not get adequate pre-purchase education and secured mortgages with questionable affordability. Option ARMs, interest only and stated income loans enabled those who could not otherwise do so to move into homeownership. Unfortunately, that access has come at steep price for many.

These homeowners need counseling on their options to preserve homeownership, when feasible, or how to minimize their financial loss when there is no way to preserve the home. There are few easy answers to homeowner's mortgage difficulties.

At ByDesign, this counseling is provided in intensive, typically 2-hour, sessions, with a HUD-certified counselor. A counseling session includes a detailed analysis of the household budget, including income and expenses, and a review of the home equity position, the loan, and the credit report. An overview and analysis of the options to preserve homeownership are discussed and next steps defined. When appropriate, the counselor will work with the homeowner to call the lender's loss mitigation department.

Lender, national and local initiatives, such as No Homeowner Left Behind, all play a role in reaching out to homeowners. .

This surge in calls from homeowners has created a significant strain on ByDesign's resources. Historically, ByDesign's primary support for default counseling has been annual competitive-bid funding that we receive from HUD. This year's funding supported less then two month's worth of activity. We have reached out to the lending community for support and have received a luke-warm response. Some lenders, such as Wells Fargo, have provided financial support for counseling and work with us in the community to reach out to homeowners facing difficulties. Others have little interest in supporting any local capacity. This is unfortunate, as many homeowners prefer to work with counselor within their community, but with the limited financial support we received, we are only providing approximately forty counseling sessions a week although we refer many callers to the Neightborworks hotline.

ByDesign has had a mixed response from the lending community when trying to workout options for preserving homeownership. Getting in touch with the lenders' loss mitigation staff can be a challenge and, when we are able to speak to a staff member, workable options are frequently not available.

While we have seen some homeowners where there is no other option other than loss of the home, there are a significant number of homeowners who would have the ability to make their mortgage payments IF a loan modification were available. Changing the variable rate into a fixed rate and putting the payments in arrears at the end of the loan were the options our counseling staff would most like to see from lenders but neither of these are generally available.

While the primary goal of default counseling is to preserve homeownership, there is significant value to the homeowner to receive counseling even if the end result is the loss of the home. In that case, counseling on how to secure rental housing, how to begin to rebuild credit and how to access other supportive services are invaluable in helping the individual and the family move beyond the crisis of losing their home.

Finally, early outreach to homeowners is the most effective. Mortgage check-up events and counseling on the family budget before there is a mortgage delinquency are two effective local strategies. But, to reach out to homeowners and to provide these services takes funding that is not currently available.

111 Pine Street, Suite 1100, San Francisco, CA 94111-5613 (415) 263-8500
300 South Spring Street, Suite 15513, Los Angeles, CA 90013-1204 (213) 897-2085
1810—13th Street, Sacramento, CA 95814-7118 (916) 322-5966
7575 Metropolitan Drive, Suite 108, San Diego, CA 92108-4421 (619) 682-7227
Consumer Compliance (800) 622-0620

State of California Arnold Schwarzenegger, Governor
Barry R. Sedlik, Acting Secretary, Business Transportation & Housing Agency

Department of Financial Institutions http://www.dfi.ca.gov

Monthly Bulletin

Volume 10, Number 7 January 2007

Nontraditional Mortgage Product Risks

It is the expectation of the Department of Financial Institutions that all licensees comply with the October, 4, 2006 "Final Guidance on Nontraditional Mortgage Product Risks" ("Guidance") issued by the federal regulatory agencies to address the risks posed by nontraditional residential mortgage products. Also known as "alternative" or "exotic" mortgage loans, they include "interest-only" mortgages and "payment option" adjustable-rate mortgages. These products allow borrowers to exchange lower payments during an initial period for higher payments later. The Guidance is intended to promote consistent regulation in the mortgage market and to clarify how residential mortgage providers can offer nontraditional mortgage products in a way that clearly discloses the risks borrowers may assume. These products are offered to a wide spectrum of borrowers who may not otherwise qualify for a similar-size mortgage under traditional terms and underwriting standards. While many of these features exist in other adjustable-rate mortgage products, the concern is elevated with nontraditional products because of the lack of principal amortization and the potential for negative amortization. In addition, institutions are increasingly combining these loans with other features that may compound risk ("risk layering"). These features include making simultaneous second-lien mortgages and relying on reduced or no documentation in evaluating an applicant's creditworthiness. Licensees should read and familiarize themselves with the Guidance and carefully scrutinize their risk management processes, policies, and procedures in this area. Institutions with sound underwriting, adequate risk management, and acceptable portfolio performance will not be subject to criticism merely for offering such products.

Consumer Information on Nontraditional Mortgage Loans

The federal bank, thrift, and credit union regulatory agencies have published a new resource that can help consumers make more informed choices when considering nontraditional mortgage loans. *Interest-Only Mortgage Payments and Payment-Option*

ARMs – Are They for You? features a glossary of lending terms, a mortgage shopping worksheet, and a list of additional information sources. This information can help consumers, whether buying a house or refinancing a mortgage, decide if an interest-only mortgage (an I-O mortgage) or an adjustable- rate mortgage (ARM) with the option to make a minimum payment (a payment-option ARM) is right for them. The publication stresses the importance of understanding key mortgage loan terms, and warns of the risks consumers may face. The interagency information is available on each agency's web site or on the DFI website. A PDF (Portable Document Format) version is provided so that consumer groups, financial institutions, agencies, and other organizations can download and print copies for distribution to their clients and customers. It includes a space on the back panel for organizations to provide their own contact information. The web addresses are:

http://www.federalreserve.gov/pubs/mortgage_interestonly/default.htm
http://www.fdic.gov/consumers/consumer/interest-only/index.html
http://www.occ.treas.gov
http://www.ncua.gov/Publications/Index.htm
http://www.ots.treas.gov

Single copies of the brochure are available free of charge from:

• Publications, Mail Stop 127, Federal Reserve Board, 20th and C Streets, N.W., Washington, DC
20551; 202-452-3245

• FDIC Public Information Center, 3501 North Fairfax Drive, Room E-1002, Arlington VA
22226; 877-ASK-FDIC, 703-562-2200

Warning Notice - Fraudulent Cashier's Check Activity

Recently, DFI has observed an upsurge in the use of fraudulent cashier's checks. Typical scenarios involve unwitting consumers who receive fraudulent cashier's checks in payment for goods they are selling via Craigslist or E-Bay. Sometimes the checks are for more than the purchase price, with a request to wire the difference back to the buyer. In other scenarios, consumers receive a letter informing them that they have received an unexpected windfall. A large denomination cashier's check is enclosed and the consumer is instructed to deposit the check and wire a specified amount to the remitter for "processing fees". In each case, the consumer, who believes the check to be good, deposits it into his or her account and, if requested, wires funds as instructed by the remitter. Some time later, the item is

State of California

Arnold Schwarzenegger, Governor
Dale E. Bonner, Secretary, Business Transportation & Housing Agency

Department of Financial Institutions **http://www.dfi.ca.gov**

Monthly Bulletin

Volume 10, Number 10 **April 2007**

Douglas Kirkpatrick Appointed as Deputy Commissioner

Department of Financial Institutions Commissioner Michael A. Kelley announced the appointment of Douglas Kirkpatrick as Deputy Commissioner for the Department of Financial Institutions, San Diego/Orange County Region effective April 7, 2007.

Mr. Kirkpatrick started his career with the California Department of Corporations in 1974. In 1987 he was appointed Special Administrator for California's industrial loan companies and played a key role in their transition to federal deposit insurance. In 1996, Mr. Kirkpatrick was given the additional responsible as Special Administrator for all California state chartered credit unions.

When the Department of Financial Institutions was created in 1997, Mr. Kirkpatrick joined DFI as an Assistant Deputy Commissioner. He is a graduate of California State University Northridge and a Certified Examinations Manager. Mr. Kirkpatrick is responsible for supervising commercial and industrial banks in the San Diego/Orange County region. He is headquartered in the Department's Los Angeles office.

DFI Encourages Licensees to Work with Subprime Borrowers in Distress

On April 16, 2007, the Department participated in a meeting at the Federal Department Insurance Corporation headquarters on the turmoil in the market for so-called subprime mortgages. The meeting was attended by high-level representatives of regulatory agencies, consumer groups, bankers and other participants in the mortgage industry. Consensus was reached amongst those in attendance that it is in everyone's interest to work toward keeping deserving borrowers in their homes.

The Department of Financial Institutions requests that licensees involved in subprime lending to develop policies so that, wherever possible and consistent with sound lending practices, borrowers in distress are afforded all options that will reduce their risk of foreclosure.

Procedures to Formally Appeal Examination Findings

In October 1991 Superintendent of Banks James Gilleran sent a letter to bank chief executive officers advising them that if a bank disagreed with the findings of an examination, a procedure to appeal was available. Superintendent Conrad Hewitt continued that process in 1995. Commissioner Michael Kelley plans to continue that process.

To be effective, the appeal process must be consistent and uniform in its application. The procedures that are to be followed to assure consistency and uniformity include:

- All findings of the examination are to be discussed by the Examiner-In-Charge with bank management at exit meetings, and the examiner is to note any material disagreement with the findings. After review by departmental supervisory staff, findings and classifications are communicated to the bank's board of directors through the Report of Examination and accompanying transmittal letter.

- Bankers will be afforded an opportunity to respond to the findings including providing new/additional information or rebuttal (generally in the response to the report of examination).

- Bankers may discuss unresolved differences with the responsible (1) Assistant Deputy; (2) Deputy Commissioner and (3) the Senior Deputy/Chief Examiner.

- If not resolved, bankers may discuss any differences personally with the Commissioner.

DFI and Antequera, Inc. Enter into an Agreement

On April 12, 2007, the Commissioner of Financial Institutions entered into a settlement agreement with Antequera, Inc. ("Antequera"), in which Antequera agreed to pay $15,000 to the Department, and the Commissioner agreed to take no further action with respect to alleged violations of the Financial Code related to unapproved and unlicensed branch offices.

Commercial Bank Activity

New Bank

1st Capital Bank
5 Harris Court, Building N, City and County of Monterey
(831) 264-4000
(831) 264-4001 (fax)
Officers: Clyde F. Rowden, President and Chief Executive Officer
Jayme C. Fields, Chief Financial Officer
Geoffrey M. Loftus, Chief Credit Officer
Daniel L. Walls, Chief Lending Officer
Capitalization: $31,576,990.00
Website: http://www.1stCapitalBank.com
Opened: 4/16/07

Regulators, execs agree on goal of keeping distressed borrowers in homes, FDIC chairman says

The Associated Press
Published: April 16, 2007

WASHINGTON: A high-level group of U.S. officials, bankers and mortgage industry executives meeting Monday agreed on a goal of keeping deserving borrowers with high-risk mortgages in their homes at a time of rising foreclosures, a key banking regulator said.

Financial institutions making changes to the terms of home loans — such as extending the initial low, or "teaser" interest rates on adjustable-rate mortgages — may help ease the distress of borrowers who are making regular payments but facing possible default, said Sheila Bair, chairman of the Federal Deposit Insurance Corp.

Bair organized the unusual seven-hour meeting at FDIC headquarters on the turmoil in the market for so-called subprime mortgages, which are higher-priced home loans for people with tarnished credit or low incomes who are considered greater risks. In recent weeks, the distress has roiled financial markets and stoked anxiety that it could spill over into the broader economy.

Adjustable-rate mortgages are especially prevalent in the subprime market. They are considered higher-risk loans because they typically draw borrowers in with an initial teaser interest rate, which can rise markedly over time.

There was consensus among the regulators, Wall Street executives, bankers and others in attendance that "it will be in everyone's interest to keep borrowers in their homes," Bair said in a telephone interview after the closed-door meeting.

"It's going to be a very challenging task. ... We're not going to be able to save everybody," Bair said. But regulators can try to serve as catalysts for financial institutions to make changes, she said.

In addition to Bair, officials from the Treasury Department, the Federal Reserve and the Securities and Exchange Commission attended the meeting. Executives of mortgage finance giants Fannie Mae and Freddie Mac, and from big mortgage lenders such as Countrywide Financial Corp. and Wells Fargo & Co. also were there, as were officials from Wall Street firms like Morgan Stanley and Bear Stearns & Co.

The meeting comes against a backdrop of mounting pressure on Congress and regulators to do something about rising foreclosures among homeowners unable to meet high payments. Millions of homeowners are said to be at risk of losing their homes in coming years. While a number of politicians, consumer advocates and community activists are clamoring for Congress to act, industry interests and some Republican lawmakers are warning that new restrictions on mortgage lending could choke off credit to those who most need it.

Democrats in power positions on Capitol Hill have started drafting legislation to curb abusive mortgage lending practices that especially target minorities and the elderly, putting people into home loans that they cannot afford to repay.

The home-mortgage business has exploded in the last two decades, with big Wall Street investment firms buying loans in bulk from banks and other lenders and bundling them into securities to be sold to investors, spreading the risk.

The role of major Wall Street investment firms in the subprime market debacle is under scrutiny. In Massachusetts, the state's top securities regulator recently issued subpoenas to two major firms — UBS Securities LLC and Bear Stearns — as part of an investigation into whether their analysts' research ignored subprime lenders' mounting financial problems.

As published in the International Herald Tribune 4/16/2007

DFI Sparklist: sent 5/7/2007

Due to the current subprime lending and foreclosure issues, the Department urges that all licensees that make, buy or sell residential mortgages attend *Preserving Homeownership—Preserving Communities* a free seminar sponsored by the Community Affairs Offices of the Federal Reserve Bank of San Francisco, the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Office of Thrift Supervision. This seminar will focus on collaborative solutions for borrowers and neighborhoods affected by foreclosures. Sessions are being offered at six cities in California, Nevada and Arizona during May and June. To register for this important event, visit www.frbsf.org/community. Please note that space is limited to the capacity of the venue. To accommodate a diverse attendance, registration may be restricted to two per organization.

Preserving Homeownership—Preserving Communities

Sponsored by the Community Affairs Offices of the Federal Reserve Bank of San Francisco
Office of the Comptroller of the Currency • Federal Deposit Insurance Corporation • Office of Thrift Supervision

Please mark your calendars for a discussion of community responses to rising mortgage defaults and foreclosures. Several indicators suggest that more homeowners may be at risk of losing their homes, threatening to reverse gains in homeownership and destabilize low-income neighborhoods. In May and June, we will explore these trends in six cities in Arizona, California, and Nevada. These sessions will focus on collaborative solutions for borrowers and neighborhoods affected by foreclosures.

Who should attend:

Federally regulated financial institutions • State licensed mortgage lenders • Mortgage servicers • Housing counselors • Community development advocates • State, federal, and municipal government representatives

Topics to be discussed:

National and local data on foreclosures • Solutions for distressed borrowers • Strategies for foreclosure prevention • Impact of foreclosures on borrowers and neighborhoods

Date	City
May 30	San Francisco
May 31	Fresno
June 6	San Diego
June 7	Las Vegas
June 20	Los Angeles
June 28	Phoenix

To see the agenda, find contact information, and to register please go to:

www.frbsf.org/community.

There is no charge for these events, but space is limited to the capacity of the venue. To accommodate a diverse attendance, registration may be restricted to two per organization.

The Federal Reserve Board

Joint Press Release

Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
National Credit Union Administration
Office of the Comptroller of the Currency
Office of Thrift Supervision

For Immediate Release

April 17, 2007

Federal Regulators Encourage Institutions to Work with Mortgage Borrowers Who Are Unable to Make Their Payments

The federal bank, thrift and credit union regulatory agencies are encouraging financial institutions to work with homeowners who are unable to make mortgage payments. Prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower. Institutions will not face regulatory penalties if they pursue reasonable workout arrangements with borrowers.

Borrowers who are unable to make their mortgage payments should contact their lender or servicer as soon as possible to discuss available options. Examples of constructive workout arrangements include modifying loan terms, and/or moving borrowers from variable-rate loans to fixed-rate loans. Bank and thrift programs that transition low- or moderate-income homeowners from higher-cost loans to lower-cost loans may also receive favorable consideration under the Community Reinvestment Act (CRA), provided the loans are made in a safe and sound manner. Federal credit unions are exempt from CRA requirements.

The agencies want to remind their institutions that existing regulatory guidance and accounting standards do not require immediate foreclosure on homes when borrowers fall behind on payments. In addition, under the Homeownership Counseling Act, institutions are required to inform delinquent borrowers about the availability of homeownership counseling. Institutions should also consider working with reputable consumer-based organizations to help financially stressed borrowers avoid predatory foreclosure rescue scams.

The agencies' statement is attached.

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Attachment (20 KB PDF)

Media Contacts:

Federal Reserve	Deborah Lagomarsino	(202) 452-2955
FDIC	David Barr	(202) 898-6992
NCUA	Cherie Umbel	(703) 518-6337
OCC	Kevin Mukri	(202) 874-5770
OTS	Kevin Petrasic	(202) 906-6677

2007 Banking and consumer regulatory policy

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Accessibility

Last update: April 17, 2007

Statement on Working with Mortgage Borrowers

The federal financial institutions regulatory agencies[1] encourage financial institutions to work constructively with residential borrowers who are financially unable to make their contractual payment obligations on their home loans. Prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower.

Many residential borrowers may face significant payment increases when their adjustable rate mortgage (ARM) loans reset in the coming months. These borrowers may not have sufficient financial capacity to service a higher debt load, especially if they were qualified based on a low introductory payment. The agencies have long encouraged borrowers who are unable to meet their contractual obligations to contact their lender or servicer to discuss possible payment alternatives at the earliest indication of such problems.

The agencies encourage financial institutions to consider prudent workout arrangements that increase the potential for financially stressed residential borrowers to keep their homes. However, there may be instances when workout arrangements are not economically feasible or appropriate.

Financial institutions should follow prudent underwriting practices in determining whether to consider a workout arrangement. Such arrangements can vary widely based on the borrower's financial capacity. For example, an institution might consider modifying loan terms, including converting loans with variable rates into fixed-rate products to provide financially stressed borrowers with predictable payment requirements.

The agencies will continue to examine and supervise financial institutions according to existing standards. The agencies will not penalize financial institutions that pursue reasonable workout arrangements with borrowers who have encountered financial problems. Further, existing supervisory guidance and applicable accounting standards do not require institutions to immediately foreclose on the collateral underlying a loan when the borrower exhibits repayment difficulties. Institutions should identify and report credit risk, maintain an adequate allowance for loan losses, and recognize credit losses in a timely manner.

Financial institutions may receive favorable Community Reinvestment Act (CRA) consideration for programs that transition low and moderate income borrowers from higher cost loans to lower cost loans, provided the loans are made in a safe and sound manner.[2] Financial institutions, working alone or in conjunction with reputable organizations such as the Center for Foreclosure Solutions sponsored by NeighborWorks, can assist borrowers in avoiding foreclosure through credit counseling.[3] Such programs also help financially stressed borrowers avoid predatory foreclosure rescue scams.

Under the Homeownership Counseling Act, financial institutions should inform certain borrowers who are delinquent on their mortgage loans (home loans secured by a single family dwelling that is the borrower's principal residence) about the availability of homeownership counseling. The Department of Housing and Urban Development (HUD) maintains a list of approved counselors.[4]

If a service member defaults on a mortgage, the Servicemembers Civil Relief Act (SCRA) prohibits the sale, foreclosure, or seizure of service member property secured by the mortgage during the period of military service, or within 90 days thereafter. Institutions are required to notify service members of their rights under the SCRA.[5] While the SCRA requirements apply only to obligations that were originated prior to the service member's military service, the agencies encourage institutions to work with service members and their families who are unable to meet any of their contractual mortgage obligations.

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[1] The federal financial institutions regulatory agencies consist of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (collectively, the agencies).

[2] Consideration as a CRA flexible lending practice may be granted in instances where such action helps to meet the credit needs of low- and moderate-income individuals or geographies within the institution's assessment area, and is consistent with safe and sound lending practices. Also see Q&A § __.22(a)– 1 (2001 Interagency Questions and Answers Regarding Community Reinvestment). Federal credit unions are not subject to CRA requirements.

[3] Consideration as a CRA community development service may be granted in instances where such activities help to meet the credit needs of low- and moderate-income individuals or geographies within the institution's assessment area. Also see Q&A § __.12(j)– 3 (2001 Interagency Questions and Answers Regarding Community Reinvestment). Federal credit unions are not subject to CRA requirements.

[4] Information on HUD's counseling services is available at http://www.hud.gov/offices/hsg/sfh/hcc/hcs.cfm or (800) 569-4287.

[5] HUD's service member notice is available at http://www.hud.gov/offices/adm/hudclips/forms/files/92070.pdf.

STATE OF CALIFORNIA
BUSINESS, TRANSPORTATION AND HOUSING AGENCY

ARNOLD SCHWARZENEGGER, Governor
DALE E. BONNER, Secretary

DEPARTMENT OF FINANCIAL INSTITUTIONS
MICHAEL A. KELLEY, Commissioner
www.dfi.ca.gov

Monthly Bulletin

Volume 11, Number 1 **July 2007**

Subprime Mortgage Lending

The Department of Financial Institutions expects all licensees to comply with the federal financial regulatory agencies' "Statement on Subprime Mortgage Lending" issued June 29, 2007, to address issues relating to certain adjustable-rate mortgage ("ARM") products that can cause payment shock. The statement describes the prudent safety and soundness and consumer protection standards that institutions should follow to ensure borrowers obtain loans they can afford to repay. These standards include a fully indexed, fully amortized qualification for borrowers and cautions on risk-layering features, including an expectation that stated income and reduced documentation should be accepted only if there are documented mitigating factors that clearly minimize the need for verification of a borrower's repayment capacity.

Consumer protection standards include clear and balanced product disclosures to customers and limits on prepayment penalties that allow for a reasonable period of time, typically at least 60 days, for customers to refinance prior to the expiration of the initial fixed interest rate period without penalty. As noted in the statement, regulatory agencies will continue to carefully review risk management and consumer compliance processes, policies, and procedures, and take action against institutions that exhibit predatory lending practices, violate consumer protection or fair lending laws, engage in unfair or deceptive acts or practices, or otherwise engage in unsafe or unsound lending practices.

The statement reinforces the April 17, 2007 interagency "Statement on Working with Borrowers," in which the agencies encouraged institutions to work constructively with residential borrowers who are financially unable or reasonably expected to be unable to meet their contractual payment obligations on their home loans. Workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower.

Deputy Commissioner Peter A. Van Hoecke Retires

Peter A. Van Hoecke, Deputy Commissioner of Legislation and Policy retired on July 31, 2007 after over 35 years with the Department. Pete joined the State Banking Department, the predecessor agency to the Department of Financial Institutions in 1972 as a junior examiner and held a variety of positions in the Department during his career. He served as the Legislative Liaison from 1983 to 1985, was appointed Deputy Superintendent of Banks – Sacramento in 1991, and Deputy Superintendent of Banks – Office of Policy, Planning & Research from 1992 -1996. He was appointed Deputy Commissioner of Legislation and Policy in March 2005.

To: The CEOs of All State-Chartered Financial Institutions and Others in the Financial Services Industry

From: Michael A. Kelley, Commissioner of Financial Institutions

Re: The Servicemembers Civil Relief Act of 2003 (SCRA) - Mortgage Relief for Active Duty Military Members

The Department of Financial Institutions (DFI) regularly reminds financial institutions of the Servicemembers Civil Relief Act (SCRA) 50 USC App. §§ 501-596, the revised and updated provisions of the Soldiers' and Sailors' Civil Relief Act of 1940. The SCRA is a federal statute passed by Congress and signed by President Bush in 2003 to allow military members to suspend or postpone some civil obligations so that the military member can devote his or her full attention to military duties. Some of the benefits under the SCRA extend to dependents of active duty military members as well.

The SCRA requires a lender to lower its interest rate to 6 percent on loans made to qualified borrowers prior to their entry to military service. The 6 percent interest rate is to remain in effect throughout the borrower's term of active duty. Under the SCRA, no interest above 6 percent may accrue for credit obligations (that were established prior to active duty or activation) while on active duty, nor can that excess interest become due once the servicemember leaves active duty. Interest over and above the 6 percent threshold is permanently forgiven. Furthermore, the monthly payment must be reduced by the amount of interest saved during the covered period. In addition to the capped interest rate, other provisions include providing temporary relief from paying mortgages and also foreclosure protection.

The Act requires some action to invoke the protections under the statute. For example, to obtain a reduction of pre-active duty mortgage or credit card interest rates, military personnel must send the lender/creditor a written request and a copy of military mobilization orders. Military personnel that think their rights under the SCRA that may have been violated or qualify for protection under the SCRA are encouraged to contact a military legal assistance office to talk with an attorney about their specific case.

A copy of the SCRA downloaded from the Global Legal Information Network (GLIN) http://www.glin.gov in PDF format is attached for your convenience.

The Department of Housing and Urban Development (HUD) provides a SCRA Questions and Answers document for lenders on the HUD Web site at:
http://www.hud.gov/offices/hsg/sfh/nsc/qasscra2.cfm.

HUD also provides a Q&A for homeowners at:
http://www.hud.gov/offices/hsg/sfh/nsc/qasscra1.cfm.

Additional information is available from the Department of Defense:
http://www.defenselink.mil/specials/Relief_Act_Revision/.

PRESS RELEASE 07-17
July 23 2007
Contact: Alana Golden, Public Information Officer
(916) 323-7012 or (916) 322-5966
www.dfi.ca.gov

Commissioner of Financial Institutions Participates in Consumer Home Mortgage Town Hall Events

(San Francisco, CA) Department of Financial Institutions (DFI) Commissioner Michael A. Kelley attended Consumer Home Mortgage Town Hall events on Saturday, July 14, 2007 at the California Baptist University - Yeager Center in Riverside and on Saturday, July 21 at Our Lady of Holy Rosary Church in Sun Valley.

The Riverside and Sun Valley events are part of a series of community events coordinated by the Department of Consumer Affairs, State and Consumer Services Agency, and the Business, Transportation and Housing Agency in partnership with local legislators, to help educate the public about homeownership. The Riverside Town Hall was hosted by Senator Bob Dutton and Assembly Members John Benoit, Paul Cook, Bill Emmerson, and Kevin Jeffries. The Sun Valley event was hosted by Senator Padilla and Assembly Member Felipe Fuentes.

State officials and experts provide presentations and information on mortgages and making the most of homeownership. Efforts also include consumer education, enforcement against unscrupulous licensees, and new regulations to ensure consumers better understand the loan products that are available.

"Together, we can assist borrowers by helping them obtain information on financial transactions including mortgages and refinancing, tips on working with lenders, and filing a complaint with the appropriate regulatory agency if a borrower believes a violation of the law has occurred," said Commissioner Kelley. "We are encouraging consumers to bring their loan documents and/or all financial-related questions and get straight answers from state regulators," Kelley added.

In addition to the Town Hall events, a Consumer Home Mortgage Web site was launched in May, www.yourhome.ca.gov, which is also available in Spanish at www.sucasa.ca.gov and provides consumers with links to an array of helpful mortgage resources. The online information allows consumers to address their unique situations, with links for consumers who are looking to purchase a home and for those who need help with an existing mortgage. The Web site also posts scheduled town hall event information.

DFI supervises over 700 financial institutions. The Department is responsible for administering state laws regulating state-licensed financial institutions: banks, credit unions, industrial banks, savings associations, trust companies, offices of foreign banks, issuers of travelers' checks and payment instruments (money orders), and money transmitters. DFI reports to Business, Transportation & Housing Agency Secretary Dale A. Bonner and Gov. Arnold Schwarzenegger.

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Press Releases

Joint Release

Federal Deposit Insurance Corporation
NeighborWorks® America

FOR IMMEDIATE RELEASE
July 16, 2007

Media Contacts
FDIC: David Barr (202) 898-6992
NeighborWorks: Douglas Robinson (202) 220-2360

FDIC, Neighborworks® America Form National Partnership To Help Consumers at Risk of Foreclosure

The FDIC – working through its new Alliance for Economic Inclusion (AEI) initiative – and the NeighborWorks® Center for Foreclosure Solutions have partnered to promote foreclosure-prevention strategies for consumers at risk of foreclosure from subprime and nontraditional mortgage lending. The partnership will focus its efforts in nine markets around the country that are served by both organizations.

"More and more consumers with subprime and so-called 'hybrid' mortgage products are facing the very real prospect of losing their homes through foreclosure as their payments begin to rise and become unaffordable," said Sheila C. Bair, FDIC Chairman. "We need to find workable solutions to keep these good-faith borrowers in their homes, which is the goal of the partnership announced today. No one gains from foreclosure – not the lender nor, least of all, the homeowner.

"I'd like to acknowledge FDIC Director Tom Curry, who also serves as Chairman of NeighborWorks® America, for his tireless efforts in helping to create this important partnership," added Chairman Bair.

"The NeighborWorks® Center for Foreclosure Solutions is at the forefront of developing and implementing strategies to address the current foreclosure crisis," said Ken Wade, NeighborWorks® America CEO. "NeighborWorks® is pleased to partner with the FDIC to leverage the expertise of both organizations to maximize impact and ensure that struggling homeowners have options."

The partnership announced today will focus its efforts in the Greater Boston area; Wilmington, DE; Baltimore, MD; South Texas (Houston/Austin); Chicago; the Louisiana and Mississippi Gulf Coast; Alabama's Black Belt; Kansas City; and Los Angeles.

The FDIC's Alliance for Economic Inclusion in each of these markets is a broad-based local coalition of banks and thrifts, community leaders, public officials and others seeking to improve access to banking products and services for underserved populations. The partnership between the FDIC's AEI and NeighborWorks® aims to build capacity at the local level to reach out to at-risk homeowners, identify successful foreclosure intervention strategies and deliver homeownership education counseling.

Within each of the AEI coalitions serving these markets, a foreclosure solution and prevention working committee will be established. Each committee will comprise local financial institutions, the local NeighborWorks® of America-Neighborhood Housing Services affiliate and other partners working on foreclosure issues.

The partnership's initial action plans include:

- Conducting outreach to identify and help at-risk homeowners;
- Increasing lenders' support for foreclosure intervention;
- Promoting awareness of abusive foreclosure-rescue schemes and deceptive marketing and advertising practices;
- Encouraging loan workouts as an alternative to foreclosure or counseling if this is not feasible;
- Promoting best intervention practices in mortgage lending and servicing programs for consumers at risk of foreclosure who could still qualify for financing with flexible terms and credit enhancements; and
- Expanding support of the NeighborWorks® Center for Foreclosure Solutions National Partnership between leading members of the financial, mortgage, insurance and nonprofit sectors.

Through this broad-based collaboration, regulators, government officials, financial institutions, community and nonprofit groups, as well as consumers will have a role in identifying, developing and tailoring foreclosure intervention strategies that will be responsive to the local needs of their market.

"This partnership is a giant step in the right direction," said Thomas J. Curry, FDIC Director and Chairman of NeighborWorks® America. "It provides a unique opportunity to ease the tremendous financial and social impact of foreclosures on borrowers, lenders and communities."

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About FDIC

Congress created the Federal Deposit Insurance Corporation in 1933 to restore public confidence in the nation's banking system. The FDIC insures deposits at the nation's 8,650 banks and savings associations and it promotes the safety and soundness of these institutions by identifying, monitoring and addressing risks to which they are exposed. The FDIC receives no federal tax dollars – insured financial institutions fund its operations. FDIC press releases and other information are available on the Internet at www.fdic.gov, by subscription electronically (go to www.fdic.gov/about/subscriptions/index.html) and may also be obtained through the FDIC's Public Information Center (877-275-3342 or 703-562-2200).

About NeighborWorks® America

NeighborWorks® America creates opportunities for people to improve their lives and strengthen their communities by providing access to homeownership and to safe and affordable rental housing. To date, we have assisted nearly 850,000 low- to moderate-income families with their housing needs. Much of our success is achieved through our support of the NeighborWorks® network – more than 235 community development organizations working in 4,400 urban, suburban and rural communities in all 50 states, the District of Columbia and Puerto Rico. In the last five years, NeighborWorks® organizations have generated more than $12.4 billion in reinvestment in these communities. NeighborWorks® America is the nation's leading trainer of community development and affordable housing professionals. www.nw.org.

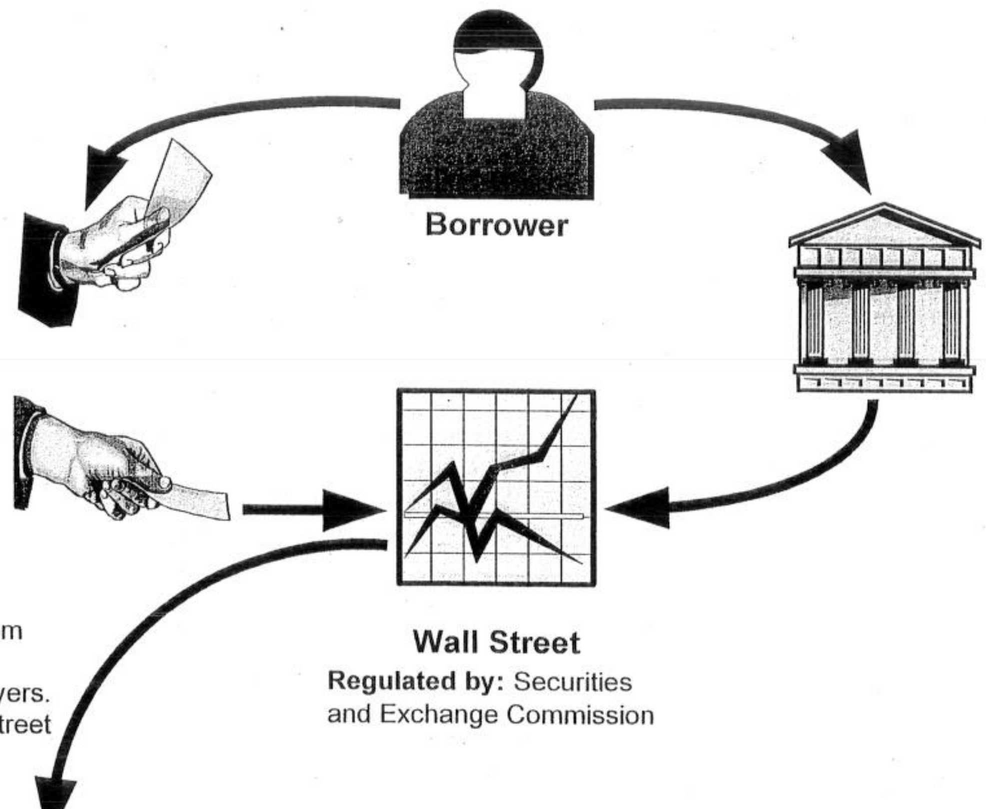
FDIC-PR-59-2007

Last Updated 07/16/2007 communications@fdic.gov

Subprime Mortgage Lenders Diagram

How lenders work

People who borrow money to buy a home generally have two sources of traditional banks or mortgage brokers. Whichever they choose, their mortgage passes through the hands of Wall Street bankers, who buy and sell pools of mortgages as bonds. How the lending system works:



Mortgage broker
Obtains loan from bank or mortgage lender

Mortgage lenders
Regulated by: Individual states
Percentage of borrowers who use them: 60%

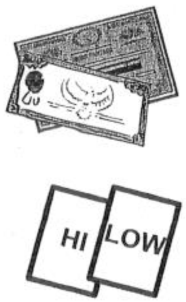
Mortgage Lenders:
- Are financed by loans from Wall Street banks.
- Lend money to home buyers.
- Sell mortgages to Wall Street banks to repay loans

Traditional Bank
Regulated by: State of California Department of Financial Institutions

Percentage of borrowers who use them: 40%

Banks:
- Lend Money to home buyers
- Sell mortgages to Wall Street Investment banks

Wall Street
Regulated by: Securities and Exchange Commission



Investment banks, such as Goldman Sachs, Morgan Stanley and others:
- Buy mortgages from banks and mortgage lenders. The mortgages are placed in groups to reduce the risk of default.
- The groups are reshuffled into "tranches", rated by risk. The higher the risk, the higher the return.

Like bonds, tranches are sold to investors.
Percentage of agencies that bought tranches in 2006:

Foreign Investors	17%
Commercial Banks	16%
Fannie Mae, Freddie Mac	14%
Governments	11%
Insurance Companies	8%
Mutual Funds	7%
Pension Funds	4%
Other	13%

Data Report: Non-Traditional Mortgage Survey of State Chartered Financial Institutions

Prepared by Kristine De Young
MPA Candidate, University of Southern California

California Department of Financial Institutions

March, 12, 2007

State Chartered Bank *and* Credit Union Involvement with Non-Traditional Mortgage Products

(Numbers are approximate.)

Type of Non-traditional Mortgage Products	Retained				Sold			
	# of Institutions Reporting	# of Loans	Dollars (In Thousands)	Average $ Per Loan	# of Institutions Reporting	# of Loans	Dollars (In thousands)	Average $ Per Loan
Interest-only Mortgage Loan	68	6,190	2,285,089	369,000	39	11,330	3,667,882	323,000
Payment Option ARM	9	523	74,707	142,000	14	328	120,526	367,000
Reduced Documentation	26	3,276	958,257	292,000	35	65,121	15,044,657	231,000
Simultaneous Second-lien Loan	44	2,178	280,929	128,000	27	44,133	3,033,690	68,000
Other	12	1,125	127,660	113,000	3	9	2,103	233,000
All Non-traditional Mortgage Products		13,292	3,726,642	280,000		120,921	21,868,858	180,000

State Chartered Banks Only

(Numbers are approximate.)

Type of Non-traditional Mortgage Products	Retained				Sold			
	# of Institutions Reporting	# of Loans	Dollars (In Thousands)	Average $ Per Loan	# of Institutions Reporting	# of Loans	Dollars (In thousands)	Average $ Per Loan
Interest-only Mortgage Loan	15	1594	764,474	479,594	17	1550	449,027	289,694
Payment Option ARM	3	171	59,512	348,023	10	318	117,042	368,056
Reduced Documentation	10	2065	816,401	395,351	20	3108	935,615	301,034
Simultaneous Second-lien Loan	7	510	80,563	157,966	13	658	249,921	379819
Other	2	24	24,176	1,007,333	2	7	1453	207,571
All Non-traditional Mortgage Products		4364	1,745,126	399,891		5641	1,753,058	310,770

State Chartered Credit Unions Only

(Numbers are approximate.)

Type of Non-traditional Mortgage Products	Retained				Sold			
	# of Institutions Reporting	# of Loans	Dollars (In Thousands)	Average $ Per Loan	# of Institutions Reporting	# of Loans	Dollars (In thousands)	Average $ Per Loan
Interest-only Mortgage Loan	48	4499	1,445,792	321,358	18	243	95,798	394,230
Payment Option ARM	5	351	14,298	40,735	3	9	2,734	303,777
Reduced Documentation	14	1211	141,856	117,139	12	214	80,709	377,144
Simultaneous Second-lien Loan	35	1667	199,760	119,832	11	144	20,174	140,097
Other	9	1095	98,786	215,402	1	2	650	325,000
All Non-traditional Mortgage Products		8823	1,900,492	215,402		612	200,065	326,903

State Chartered Industrial Banks Only

(Numbers are approximate.)

Type of Non-traditional Mortgage Products	Retained				Sold			
	# of Institutions Reporting	# of Loans	Dollars (In Thousands)	Average $ Per Loan	# of Institutions Reporting	# of Loans	Dollars (In thousands)	Average $ Per Loan
Interest-only Mortgage Loan	3	97	74,823	771,371	2	9537	3,123,057	327,467
Payment Option ARM	1	1	897	897,000	1	1	750	750,000
Reduced Documentation	0	0	0	0	2	61,799	14,028,333	226,999
Simultaneous Second-lien Loan	1	1	606	606,000	2	43,331	2,763,595	63,778
Other	1	6	4698	783,000	0	0	0	0
All Non-traditional Mortgage Products		104	81,024	779,076		114,668	19,915,735	173,681

THE GREENLINING INSTITUTE

A MULTI-ETHNIC PUBLIC POLICY RESEARCH AND ADVOCACY INSTITUTE

PRESS RELEASE

Friday, August 17, 2007

Contacts:
Bob Gnaizda
Policy Director
510-926-4006
Cell: 415-307-3320
robertg@greenlining.org

Andrea Nieves
Anti-Foreclosure Policy Analyst
510-926-4020
Cell: 925-451-9733
andrean@greenlining.org

California Senate Banking Committee Hearing and Ten Billion Dollar Private National Anti-Foreclosure Fund

Date: August 21st, 9:30 am
Location: State Capitol Building-Sacramento

Sacramento- On August 21st at 9:30 am, California Senate Banking Committee Chairman Michael Machado will hold a hearing on the growing foreclosure crisis.

Greenlining Institute, a multiethnic public policy and advocacy center, will be testifying. It will be submitting a proposal that is now being discussed with all four major banking regulators and the House Financial Services Committee. The proposal is for the Federal Reserve Chairman Ben Bernanke, supported by other federal regulators and state and federal legislators, to call upon the major investment houses and banks to immediately create a $10 billion national and private anti-foreclosure fund. This is similar to the $3.8 billion Alan Greenspan-led bailout of Long Term Capital Management hedge fund in 1998, when a consortium of almost a dozen financial institutions rescued the fund and the nation from a major financial crisis. The proposal is attached.

The Greenlining Institute will testify that it supports CRC's proposal for a six-month moratorium on foreclosures for those who are not speculators and were, in fact, true victims. Particular emphasis should be placed on the 70% of Americans who live from paycheck to paycheck; that is those at 120% or below median income. Although Greenlining favors a wide range of restrictions on exotic and dangerous adjustable rate mortgages, it will offer a cautionary note to the Senate Banking Committee that the unintended consequences could be an artificial tightening of credit that, in effect, eliminates 70% of Californians from homeownership.

Len Canty, the Chairman of the Black Economic Council, stated:

> "For decades the Federal Reserve has bailed out the wealthy. It is now time for Federal Reserve Chairman Bernanke to rescue two million victims of corporate greed by creating a ten billion dollar loss mitigation fund that is privately financed."

On August 3, 2007, Greenlining led the first protest in California against an investment bank (Bear Stearns) and the first protest at the Federal Reserve Bank of San Francisco on the foreclosure crisis. American Banker article attached.

# # #

The Greenlining Institute is a multiethnic public policy and advocacy think tank that advocates for low income and minority communities through economic development, consumer protection, health advocacy, campaign finance reform, civil rights, and leadership development. (www.greenlining.org)

THE GREENLINING INSTITUTE
1918 UNIVERSITY AVENUE, 2ND FLOOR BERKELEY, CA 94704
PHONE: (510) 926-4000 FAX: (510) 926-4010 http//www.greenlining org

August 15, 2007

Governor Randall Kroszner
Federal Reserve
20th and C Streets, NW
Washington, DC 20551
SENT VIA FACSIMILE
(202) 872-7555

Federal Reserve as Catalyst for $10 Billion Private Anti-Foreclosure Fund

Dear Governor Kroszner,

On behalf of Greenlining Institute and the low income communities we represent, we would like to thank you for taking the time to consider an alternative loss mitigation plan. As we discussed with you on August 14th, our proposal is a far more precise instrument in minimizing foreclosures and declines in home values than an interest rate cut. Our plan also has many precedents, such as the Federal Reserve's 1998 leadership in the $3.8 billion bailout of Long Term Capital Management. It is also our hope that, if we act quickly and wisely, there will be no need for any federal funds to resolve this crisis.

Our proposal is as follows:

<u>$10 Billion Anti-Foreclosure Fund</u>

1) The Federal Reserve, hopefully with the support of the OCC, OTS, and the FDIC, will call an emergency meeting of major banks and investment banks to discuss a minimum of a $10 billion private fund for adjustable rate mortgage loan modification.
2) This fund would be used only to assist non-speculators at 120% or below median income. Today, the greatest problems in terms of foreclosures and declining home values are among the 70% of Americans who live paycheck to paycheck.
3) If necessary, Congress may consider a matching $10 billion, but only after the first ten billion is exhausted.
4) An April 13, 2007 CNNMoney article states that the average cost of loan modification is likely to be $16,000.[1] Greenlining estimates that it is quite possible that less than

[1] Stephen Gandel, "Subprime bailouts would get costly," CNNMoney.com, 05/13/07.

one million families will have to be assisted in order to stabilize home prices and slow down the foreclosure rate that is being fueled by declining home prices.

5) It should be noted that the vast majority of regulated financial institutions that have loss mitigation plans have very limited funds available and only assist a small number of those in need.[2] In part, this is due to the vast majority of subprime mortgages no longer being in the hands of the bank originator. It is estimated that two-thirds of the more than $1.2 trillion in subprime lending in '05 and '06 was either originated, packaged, or securitized by investment banks. Consequently, it is critical that an institution as venerable as the Federal Reserve act to incorporate banks and investment banks to solve this crisis.
6) It is possible that the real costs of loan modification are less, since Fannie Mae studies say that half or more of subprime borrowers could have been eligible for prime rates.[3]
7) Administration of the fund could be supervised by the Federal Reserve, a combination of the four main banking regulators, or possibly by HUD and/or Fannie Mae/Freddie Mac. An alternative, which we would prefer, is to have the financial institutions, once they commit to the $10 billion, develop their own efficient operational system.

Thank you again for considering our proposal. Only the Federal Reserve has the power to solve the foreclosure crisis quickly and effectively. Please share this with Chairman Bernanke and feel free to contact us if you have additional questions or comments.

Regards,

Bob Gnaizda	Orson Aguilar	Andrea Nieves
Policy Director	Associate Director	Anti-Foreclosure Policy Analyst

cc: Sandy Braunstein

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[2] See the 2004 HUD study "Loss Mitigation Performance Analysis" comparing the programs of all the major banks in the nation.
http://hudclips.org/sub_nonhud/cgi/pdfforms/04-30a.pdf

[3] "Sheltering Neighborhoods from the Subprime Foreclosure Storm," Special Report by the Joint Economic Committee (Senator Charles E. Schumer, Chairman), April 11, 2007.

Testimony to the California Senate Banking Committee

Alan Fisher, Executive Director
California Reinvestment Coalition
August 21, 2007

Senator Machado, members of the Banking Committee and other esteemed guests:

My name is Alan Fisher. I am Executive Director of the California Reinvestment Coalition (CRC). CRC is a statewide coalition of 250 California community-based organizations that has been working for more than twenty years to increase the economic vitality of low-income neighborhoods and neighborhoods of color. In particular, we have negotiated community commitments from all of California's major banks. In the last seven years, we have been chronicling the dramatic growth and danger of subprime lending.

I am here out of concern for the 500,000 or more Californians who may lose their homes as a result of subprime loans or stated income loans (where income is not verified). We are also deeply concerned for elderly Californians or people for whom English was not their first language that have also been the victims of misleading loans.

The facts paint a horrific picture of the dimensions of this crisis for our state:

- California had the most foreclosures in the nation in the first half of this year, and the nation[1]s third highest state foreclosure rate (foreclosures per household)
- There were 17,408 California foreclosures in the second quarter of 2007 which is up 799.2 percent from same quarter of the previous year.
- Six California cities were among the ten in the nation with the highest foreclosure rates in June.
- Subprime loans are four times as likely in California neighborhoods of color than white neighborhoods.
- More than 289,000 California loans were made in 2005 by lenders who have now gone out of business. This represents more than ten percent of all loans made in 2005 and nearly 1/3 of all subprime loans.

The loss of home ownership is just the first step in the economic and human impact of this crisis. If homes go vacant, neighborhoods lose value. There is a domino effect causing other homes to become in danger of foreclosure as they lose value. All these homeowners become more financially stretched and retail sales drop. Cities lose revenue and employment decreases.

At a national level, it is clear that Wall Street and the stock market have recognized the immense potential crisis that widespread foreclosures can mean to the U.S. economy. For a number of years, economists and the Federal Reserve have stated that the economy has done well based on the housing market and consumer purchases. We are now seeing a tremendous drop in the housing market and likely to see a resulting drop in consumer spending. Since the economy has been based on a rising housing market, the falling housing market could take our state and national economy spiraling down with it.

CRC and many other community organizations have been warning of the vast negative outcomes of subprime lending, stated income loans and misleading lending to the elderly and non-English speakers for all of this decade. Yet, until Wall Street investors were affected by the financial debacle, federal and state regulatory and legislative bodies turned a blind eye to this growing disaster of potentially epic proportions. A disaster that started with the hopes and dreams of many Californians to own their own home coupled with mortgage brokers and lenders with an eye on their profits rather than the financial reality of hundreds of thousands of Californians.

California's regulatory and legislative response to this crisis has been inadequate. Other states have enacted moratoriums on foreclosures to allow time for a full response to their state's mortgage crisis or have developed loan products that assisted borrowers. Neither the California legislature nor Governor Schwarzenneger has responded concretely to this crisis. The California Reinvestment Coalition hopes that the first outcome of these hearings will be for the Governor and legislature to get engaged to help families, neighborhoods and thereby the economy of all our state.

The California Reinvestment Coalition has identified three major segments necessary to the solution of this crisis:

1. Lenders need to provide flexible and clear loan modifications for borrowers in trouble or soon to be in trouble
2. Borrowers need strong community-based organizations to assist them to find ways to stay in their homes or other solutions
3. State and federal regulatory and legislative bodies need to institute strong oversight of lenders' loan modifications, require loan documents in the language of the borrower, and assist borrowers financially.

California Reinvestment Coalition members have met with the eight largest lenders and servicers to advocate for more flexibility in loan modifications and assistance to borrowers. We have heard many positive policies related by these lenders. However, CRC members assisting troubled borrowers in California communities report that those policies are uneven at best in their application in neighborhoods, and in some cases do not seem to exist in practice. We believe smaller loan servicers are even less likely to be responsive to borrowers or assist them in staying in their homes.

CRC has developed a set of Homeownership Preservation Best Practices which we believe cover the scope of needs to respond to this crisis. The legislature should find ways to support these principles:

- Strong loss mitigation policies to keep borrowers in their homes
  - Modify the loans to have fixed rates for the term of the loan before it is no longer affordable
  - This may be the most important, single thing that will assist borrowers

- Transparency
  - There need to be a clear channel of communication for counseling agencies having difficulty resolving borrowers' issues and for legal service advocates trying to fix predatory loans
  - The loss mitigation policies need to be clear to borrowers and the community organizations counseling them.
  - The public needs to know what the loss mitigation outcomes are. How often are loans being modified? Are policies being implemented broadly?

- Refinance Products
  - Lenders must waive prepayment penalties to allow borrowers to refinance out of bad loans.
  - Special rescue refinance loans by lenders are needed for borrowers whose own lender may have refused a loan modification.
  - The public sector should assist in this process in a manner that assists the borrowers but does not finance the lenders

- Provide grant funds to borrowers in distress
  - Some lenders are assisting borrowers with small amounts (less than $10,000)
  - This can help borrowers get caught up, or help them get a good loan modification

- Outreach and education of at risk homeowners
  - Servicers should make early contact with borrowers at potential risk of losing their home
  - Public education to borrowers regarding the need to contact servicers
  - Support for nonprofit counseling agencies to assist borrowers

- Short sale property disposition
  - Some home owners will need to sell their property and other homes will be taken in foreclosure. Lenders should offer the first opportunity to purchase to nonprofit organizations. Otherwise, it is likely that speculators will buy these properties and further depreciate the neighborhood.
  - Financial institutions and the State of California should assist nonprofit organizations with low cost financing to purchase these properties.

- Positive and strong origination oversight to prevent future problems
    - Apply all federal regulatory guidance to state regulations. The legislature should have done this by now. Many other states have done so.
    - Legislation to ensure key loan documents are in the language of the borrower.
    - There needs to be full regulatory oversight of mortgage brokers. Brokers have been responsible for much of the problem facing California borrowers.
    - There needs to be careful scrutiny so that borrowers are not steered to higher cost products including any Yield Spread Premiums
    - There should be severe restriction of stated income loans

The State of California needs to dramatically increase its activities to assist home owners in trouble. This could and should include:

- A Moratorium on Foreclosures: In Massachusetts, there is a 60-day moratorium on foreclosures that is applied to lenders. It serves to educate the public to contact servicers (which is what everyone says they want). We believe there has been no adverse effect on industry. The California Reinvestment Coalition and 125 allies called for a six-month moratorium, and the state should follow suit.
- Financial Assistance: The only California bill to offer financial assistance to borrowers, AB 1538, died in the legislature. According to the Women's Policy Institute, six other states have already taken steps to provide loan products to borrowers in distress (NY, OH, PA, MD, CO, Mass). The legislature should bring forward a bill that financially assists borrowers in trouble.
- Lender Subsidies: The lending industry should be called upon to help subsidize low-cost loans to low-income borrowers with predatory loans
- Support Counseling: The state needs to financially support the capacity of counseling agencies and legal services to assist borrowers.
- Strong Oversight: The state needs to provide strong consumer protections and regulatory oversight over mortgage lenders and brokers to ensure that this crisis cannot occur again. This includes documents in the language of the borrower.

Thank you for holding this hearing and giving CRC the opportunity to testify. Please let this hearing be only the first step to ensure effective and thorough legislative and regulatory action by the State of California. People are losing their homes. Communities are in financial danger. The economy is on a roller coaster. The State of California needs to step up and play its role to help solve this housing crisis.

CENTER FOR RESPONSIBLE LENDING

California Senate Committee on Banking Informational Hearing
Preserving the American Dream:
Home Ownership and the Subprime Mortgage Crisis
August 21, 2007

Testimony of Paul Leonard, California Office Director
Center for Responsible Lending

Introduction

First, I wish to thank Senator Machado and his colleagues on the Senate Banking Committee for convening today's informational hearing, and for inviting the Center for Responsible Lending to testify.

I want to make three main points today.

First, California has seriously lagged behind other states in its response to the meltdown in the mortgage market.

Second, there are a number of concrete steps that California can take today to minimize foreclosures and stabilize housing markets, including providing emergency funding for foreclosure prevention counseling and legal assistance, establishing a strong monitoring system for loan modifications, and a targeted refinance product to help borrowers refinance loans contingent on lender preconditions.

Third, California should enact comprehensive changes to return subprime lending to more responsible standards, including requiring lenders to evaluate the borrower's ability to repay their loans, eliminating risky product features for subprime borrowers and making structural changes in the roles of lenders, brokers and investors in the origination of mortgages.

I. California Lags Other States in Responding to the Foreclosure Crisis

There is an urgent need to address the epidemic of foreclosures in the subprime market today—the highest rate of home losses in the modern mortgage era. While other states have taken steps to raise standards on subprime lending and bold steps to prevent foreclosures, <u>California's efforts to address rising foreclosures have lagged considerably</u>. California's existing anti-predatory lending law is weaker than most states that have enacted these types of laws. The negative effects of subprime foreclosures are particularly serious for California:

- About one quarter of all subprime lending in the nation occurs in California.

PO Box 3638 Durham NC 27702-3638 • 302 W. Main Street Durham NC 27701 • Phone 919.313.8500 • Fax 919.313.8595
910 17th Street NW Suite 500 Washington DC 20006 • Phone 202.349.1850 • Fax 202.289.9009
1330 Broadway Suite 604, Oakland CA 94612 • Phone 510.379.5500 • Fax 510.893.9300
www.responsiblelending.org

- Foreclosures in California in the second quarter reached their highest level since 1988.
- The worst is yet to come: According to Moody's Economy.com, more than two million subprime adjustable rate mortgages will be resetting later this year, with an estimated $50 billion worth of mortgages due for reset in October 2007 alone.[1]
- CRL estimates that more than one in five (21.4%) subprime loans originated in California in 2005 and 2006 will end in a foreclosure.[2] We estimate that nearly 500,000 Californians will lose their homes because of subprime loans originated since 1998.

In November 2006, the federal bank regulatory agencies finalized new guidance governing underwriting practices and disclosure requirements for banks and other federally-insured depository institutions that make "non-traditional" mortgages. Thirty-six states have already implemented similar guidance for their state-regulated lenders and brokers. By contrast, California regulators needed the threat of legislation to spur the drafting of regulations, which were not released for public comment until late April 2007, and have not yet been finalized.

This is the Committee's third informational hearing on issues related to the collapse of the subprime mortgage market.[3] While states like Maine, Minnesota and North Carolina have enacted strong and bold legislation to supplement federal guidance, California has not enacted any regulatory or statutory change to help or protect California borrowers in this period. We hope that today's hearing will spur the Legislature act swiftly to assist current subprime borrowers in trouble and provide adequate protections for borrowers in the future.

We propose the state take immediate in the following areas, summarized in more detail below:

Assist Current Subprime Borrowers

- Emergency Funding for Foreclosure Prevention Counseling and Legal Services
- Monitoring Private Loan Modification Efforts—Including State Data Collection and Tracking

Protect All New Subprime Borrowers

- Ban Prepayment Penalties on All Subprime Loans
- Establish Statutory Standards for Ability to Repay: All mortgage originators should assess the ability of borrowers to repay their loan, based on the fully-indexed interest rate and fully amortized payments and with a limit on the debt-to-income ratio that is assumed.
- Require Appropriate Documentation of Income
- Require Mandatory Impoundment (or Escrow) of Property Taxes and Hazard Insurance

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[1] http://money.cnn.com/2007/07/09/real_estate/resets_are_coming/index.htm

[2] *Losing Ground, Foreclosures in Subprime Market and Their Cost to Homeowners*, The Center for Responsible Lending, December, 2006. Available at: http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31217189.

[3] Prior hearings were held January 31, 2007 and March 26, 2007.

- Establish Lender Liability for Broker Acts and Omissions When Yield Spread Premiums are Charged

II. California Can Help Borrowers Avoid Foreclosure

Providing some assistance and relief to current borrowers faced with defaults and foreclosures is a pressing priority. We propose three strategies for the state to implement: emergency funding support for foreclosure prevention counseling and legal services; creation of a monitoring system for lender loan modifications; and a targeted refinance product for borrowers who would not qualify for refinance or modifications.

1.) Emergency Support for Foreclosure Prevention Counseling and Legal Assistance: Housing counseling agencies are already stretched to the limit in responding to this foreclosure crisis. The national hotline – **-888-995-HOPE** -- that was created to assist borrowers with their mortgage problems is now receiving more than 2,000 California calls per month, the heaviest volumes in the country. This hotline provides a 24-hour resource where borrowers can call to get an honest and frank assessment of their situation, advice about when it makes sense to negotiate with servicers for a loan modification or some other form of relief, and referrals to local housing counseling agencies or legal service providers.

Housing counseling agencies and legal service providers can be critical assets for borrowers, but their limited resources are swamped attempting to assist needy borrowers. These agencies provide critical support for borrowers in navigating the complex process of negotiating with servicers through the loss mitigation process. Having a knowledgeable "trusted adviser" who has no financial stake in the outcome a borrower's negotiation can balance the knowledge gap between a professional servicer and less-knowledgeable borrowers.

Moreover, many borrowers may be victims of illegal practices and need the services of a lawyer. There are extremely few lawyers working in the state who can afford to represent individual clients with mortgage cases. The cases are often complex and time-consuming and frequently damages may not include lawyers fees.

California only receives approximately $3 million in federal counseling assistance funding and most of these resources are directed at activities to assist first-time homebuyers prepare for purchasing their homes.

California should appropriate an emergency supplement of $5-$10 million, enacted and disbursed as soon as possible to provide borrowers with critical assistance necessary to save their homes.

2.) Making Loan Modifications Work: Loan modifications offer the most promising alternative for both borrowers, taxpayers and the healthy functioning of mortgage markets in the future.

For borrowers, modifications offer the opportunity to keep them in their homes – ideally with long-term affordable mortgages. The best modifications will convert the existing adjustable rate mortgage to a long-term fixed rate mortgage at the original introductory interest rate for the life of the loan. This type of adjustment should be sufficient to achieve affordability for borrowers in markets that have not experienced significant price declines. Moreover, these initial rates were already risk-adjusted and substantially exceeded prime rates.

For borrowers in markets with steep price declines, deeper modifications may be necessary. For these borrowers, it may still be economically prudent for servicers to reduce the interest rate or the loan balance, rather than face the even higher costs of foreclosures.

For taxpayers, modifications minimize the negative consequences of foreclosures and avoid large infusions of taxpayer subsidies to avoid them. Specifically, concentrated foreclosures serve to depress the prices of nearby houses. Researchers have found that in Chicago a foreclosure on a home lowered the price of other nearby single-family homes, on average, by 1.44 percent. They also reported that the downward pressure on housing prices extended to houses that sold within two years of the foreclosure of a nearby house. [4] Concentrated foreclosures can also lead to higher municipal costs, as local governments step in to maintain the security and appearance of vacant homes in their communities.[5]

In addition, wide utilization of modifications can minimize the need for public resources to assist in providing affordable refinance options for subprime borrowers. To date, a number of states have announced new publicly-funded pools to fund refinance loans for borrowers at risk of foreclosure. States which have developed these funds include Ohio, New York, Massachussetts and Colorado.

For mortgage markets, modifications keep market incentives firmly in place. Modifications will ensure that losses are borne by the lenders and investors who are responsible for making loans without adequately evaluating the borrowers's ability to repay them. As long as the reduced cash flow of modifications exceeds the value likely to be recovered from a foreclosure, the losses are consistent with the servicers requirements to maximize cash flows for the investors in securities as a whole.

Obstacles to Modifications Are Being Removed, but Several Challenges Remain

There has been much confusion about how much latitude servicers have to modify mortgages. Securitization trusts establish the types, amounts and conditions for loan modifications under their Pooling and Servicing Agreements (PSAs) with their servicers. Credit Suisse recently reviewed a sample of 30 PSAs and concluded, "servicers generally have wide latitude with respect to loan modifications as well as other types of forgiveness."[6]

Many servicers and investors have identified a number of legal, accounting and tax issues that could prevent them from doing loan modifications at scale. However, each of these issues seems

[4] Dan Immergluck and Geoff Smith, "The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values," p. 57, 69, 72, 75 *Housing Policy Debate* (17:1) Fannie Mae Foundation (2006).
[5] Find Wall Street Journal story about Cleveland foreclosure costs.
[6] "The Day After Tomorrow: Payment Shock and Loan Modifcations," Credit Suisse Fixed Income Research, 05 April 2007. www.credit-suisse.com/researchandanalytics.

to have been resolved in a way that generally and in most PSAs does not prevent large-scale modifications. Moreover, even when there are limitations in the PSAs, it may be possible for them to be waived.[7]

Several issues continue to be challenges for large-scale loan modifications. Continuing national dialogue is underway to determine how to facilitate loan modifications where borrowers have first and second liens. While servicers are required to maximize revenues for investors, investors in certain classes or tranches of securities may be disadvantaged by the outcome of particular loan modifications. The servicers could face legal suits filed by investors.

Need for Accountability and Standardization and in Modifications

In preparation for the dramatic increases in loan resets, servicers are now expanding their loss mitigation efforts, adding staff and employing new efforts to contact borrowers early to prepare for the reset. The American Securitization Forum, an industry group has produced a *Statement of Principles, Recommendations and Guidelines on Modifications* to its members.[8]

While lenders profess a desire to avoid foreclosures, there are few mechanisms in place to track the outcomes for borrowers who participate in loss mitigation efforts. No data is regularly reported by lenders as to how many borrowers who participate in loss mitigation efforts avoid foreclosures, nor on the terms of the loan modifications they receive. The state could quickly establish a reporting and monitoring system for loans that are modified. This would greatly increase the accountability of servicers' loan modification efforts and allow the public and policymakers to track success and gain a greater understanding of which loss mitigation practices and servicers are most effective in achieving long-term affordability outcomes for borrowers.

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[7] Limitations on the number or volume of loan modifications allowed: Credit Suisse's survey found that only one-third of the PSAs reviewed put a loan or volume limitation on loan modifications, typically at 5 percent. However, these limitations can be waived with permission of certain outside parties (NIM insurer, rating agencies, or private mortgage insurers.)

Timing of eligibility for modifications: some servicers have interpreted their PSAs to permit modifications only for borrowers in default. Many believed that modification before default might violate both tax and accounting rules. Both of these concerns have been addressed to allow servicers to modify loans when default is deemed to be "reasonably foreseeable" in advance of actual default.

Tax Benefits: Earlier this year, there were concerns that modification prior to default might violate the Real Estate Investment Mortgage Investment Conduit (REMIC) tax codes – and thus the substantial tax benefits -- under which most securitizations are structured. However, the IRS has now clarified that servicers may modify loans where default is "reasonably foreseeable."

FAS 140 Accounting Standards: A similar question about the timing of loan modifications has been raised with respect to accounting standards established by Financial Accounting Standards Board, under FAS 140, the specific standards that guide securitizations. A July 24, 2007 letter from Securities and Exchange Commission Chair Christopher Cox to House Financial Services Committee Chair states clearly that the Commission's professional staff believes that loan modifications undertaken when loan default is "reasonably foreseeable" should be consistent with . . . modification activities that would have been permitted if a default had occurred.

[8] American Securitization Forum, *Statement of Principles, Recommendations and Guidelines on Modifications*, June 2007 found at
http://www.americansecuritization.com/uploadedFiles/ASF%20Subprime%20Loan%20Modification%20Principles_060107.pdf

State policymakers should also work with servicers to develop transparency and objective standards for loan modifications. Under current practice, each loan modification is developed on a case-by-case basis, subject to the financial circumstances of individual borrowers. There is little transparency for borrowers to know the best terms for which they could qualify and no guarantees that similarly situated borrowers will be treated equally. Having more streamlined and objective standards in place should simplify and streamline the modification process, and allow more consistent and successful results for borrowers and lenders. These standards would also avoid potential fair housing issues.

In sum, the legislature or Governor should immediately establish a data and monitoring system to track foreclosures and the outcomes of loan modifications for at-risk borrowers.

3.) Developing a State-Backed Refinance Mechanism: As noted above, a number of states have utilized bond funds to develop refinancing products for borrowers at risk of foreclosures, including Massachussetts, New York, Colorado and Ohio. These pools are limited and are targeted to assist low income households. Other restrictions are also often applied: no investors are eligible and borrowers who have previously extracted equity through a refinancing would be prohibited. Many states are partnering with larger financial providers, like Fannie Mae and Freddie Mac, to allow their limited resources to serve more families.

Most importantly, it is critical that any state-backed resources be contingent upon significant financial concessions by the servicers and investor. Such resources should not be used to make investors whole, and thus serving to bail them out of bad investment decisions. These concessions could include refinancing at no more than 90 percent of the current appraised or even the estimated foreclosure value of the property, whichever is less.

The legislature should direct and fund the California Housing Finance Agency to develop a refinance product to assist at risk borrowers, contingent upon servicer/investor concessions.

III. Legislative Recommendations to Protect Future Borrowers

California appears to be following the federal regulators in establishing new lending standards for subprime loans. Other states have shown much greater leadership in both establishing tougher lending standards and in strengthening procedures to rein in deceptive practices of brokers and lenders. Much stronger legislative action is needed to ensure that subprime borrowers get access to responsible credit that provides sustainable homeownership opportunities.

1. Ban Prepayment Penalties on Subprime Loans

Prepayment penalties are minimally addressed in the subprime statement, requiring only a grace period of 60 days before payment reset, during which a borrower must be able to refinance without paying a prepayment penalty.

Subprime prepayment penalties provide no economic benefit to borrowers. Some lenders have claimed that homeowners receive a lower interest rate in exchange for prepayment penalties, but subprime lenders' rate sheets tell a different story. Subprime rate sheets show that when borrowers get loans with prepayment penalties, mortgage brokers are allowed an extra commission known as a "yield spread premium." Prepayment penalties can cost borrowers thousands of dollars if they pay their loan early, and yield spread premiums increase the costs of the loan as well.

In fact, prepayment penalties serve to trap borrowers in high cost loans, or cause the borrower to lose significant home equity in order to escape them. They also limit the ability of responsible lenders to help borrowers refinance out of a loan at risk of ending in foreclosure.

Today prepayment penalties are imposed on about 70 percent of all subprime loans,[9] compared to about 2% of prime loans.[10] This disparity undermines the argument that subprime borrowers freely "choose" prepayment penalties. The unfairness of prepayment penalties is even more disturbing when you consider that they are more prevalent on subprime loans in communities of color. Borrowers in minority neighborhoods are more likely to receive prepayment penalties,[11] and minorities are at greater risk for receiving higher-priced loans than white borrowers, after controlling for legitimate risk factors.[12]

More than 35 states now regulate prepayment penalties, and at least ten states ban them outright. The recent trend is to ban prepayment penalties in the subprime market. North Carolina and Minnesota just banned prepayment penalties in subprime loans.

Like Minnesota, Maine and North Carolina, California should ban prepayment penalties for all subprime loans.

2. Establish Legislative Ability to Repay Standards

Approving loans without evaluating a borrower's ability to repay is an unfair and deceptive practice because borrowers are deceived into thinking that they can afford the loans, and they are subjected to the ultimate of injuries – the loss of their home and hard-earned equity – when rates increase, as scheduled, after two or three years. The federal regulatory subprime statement sets

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[9] *See, e.g.* David W. Berson, *Challenges and Emerging Risks in the Home Mortgage Business: Characteristics of Loans Backing Private Label Subprime ABS*, Presentation at the National Housing Forum, Office of Thrift Supervision (December 11, 2006). According to MBA data, there was a 69.2% penetration rate for prepayment penalties on subprime ARMs originated in 2006. Doug Duncan, *Sources and Implications of the Subprime Meltdown,* Manufactured Housing Institute, (July 13, 2007) A recent CRL review of 2007 securitizations showed a penetration rate for prepayment penalties averaging over 70%.

[10] *See* Berson, *supra* note 68. A recent MBA analysis shows that 97.6% of prime ARMs originated in 2006 had no prepayment penalty, and 99% of 2006 prime FRM had no penalty. Doug Duncan, *Sources and Implications of the Subprime Meltdown,* Manufactured Housing Institute, July 13, 2007

[11] Debbie Gruenstein Bocian and Richard Zhai, *Borrowers in Higher Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans*, Center for Responsible Lending (January, 2005).

[12] Debbie Gruenstein Bocian, Keith S. Ernst and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, Center for Responsible Lending (May, 2006).

out some basic guidance which while stronger than current regulatory standards provides only regulatory guidance. It is not clear that the state will have adequate capacity to enforce the guidance and individual borrowers have limited access to remedies for the shortcomings of their brokers or lenders.

Moreover the guidance fails to establish any meaningful debt-to-income standards for underwriting loans. Lenders can legally circumvent the subprime statement's ability to pay standards by simply using more elastic (and increasingly unmanageable) debt-to-income ratios.

Stronger, enforceable statutory standards should be established.

Lenders should be required to underwrite all loans based on the fully-indexed rate and fully amortizing payments, while using a debt-to-income standard (DTI) that considers property taxes, hazard insurance, and other debts. Maine, Minnesota, Ohio and North Carolina laws would serve as good models. In addition, this DTI standard should include a rebuttable presumption that the borrower had sufficient capacity to repay the loan where the lender could establish with documentation that the DTI was 50% of gross income or less.

3. Require Appropriate Documentation of Income

Verification of income is a necessary complement to effective implementation of an ability to pay standard. While lenders purport to evaluate borrowers and underwrite loans, in reality, without adequate income verification, a lender's approval of a loan is meaningless. Borrowers often do not understand that they are paying extra higher interest rate not to document their income, even though their W-2s are readily available, or that their income is overstated. Stated income loans also increase the interest rate borrowers pay for no reason and have been proven to overstate incomes, understate repayment ability, and therefore increase foreclosures. For example, a review of a sample of "stated-income" loans disclosed that 90 percent had inflated incomes compared to IRS documents, and "more disturbingly, almost 60 percent of the stated amounts were exaggerated by more than 50 percent."[13]

Fitch Ratings recently noted that "loans underwritten using less than full documentation standards comprise more than 50 percent of the subprime sector . . ."[14] "Low doc" and "no doc" loans originally were intended for use with the limited category of borrowers who are self-employed or whose incomes are otherwise legitimately not reported on a W-2 tax form, but lenders have increasingly used these loans to obscure violations of sound underwriting practices.

[13] Mortgage Asset Research Institute, Inc., *Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association*, p. 12, available at http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf (April 2006); *see also* 2007 Global Structured Finance Outlook: Economic and Sector-by Sector-analysis, FITCH RATINGS CREDIT POLICY (New York, N.Y), December 11, 2006, at 21, commenting that the use of subprime hybrid arms "poses a significant challenge to subprime collateral performance in 2007."
[14] See *Structured Finance: US Subprime RMBS in Structured Finance CDOs*, FITCH RATINGS CREDIT POLICY (New York, NY), August 21, 2006, at 4.

California should require lenders to verify and document all sources of income using either tax or payroll records, bank account statements or any reasonable alternative or third-party verification.

4. Require Impoundments (or Escrows) for Taxes and Insurance

In stark contrast to the prime mortgage market, most subprime lenders make loans based on low monthly payments that do not impound (or escrow) for property taxes or hazard insurance. By routinely omitting escrows for taxes and insurance, subprime lenders have deceived borrowers into believing that their mortgage will be affordable. This deceptive practice is also unfair, since borrowers are often required to refinance their mortgage to raise the funds to pay the required fees, needlessly causing substantial injuries of approximately 8% of the loan amount (3% in upfront points and fees, 2% in third party fees, 3% in prepayment penalties), or $24,000 for a $300,000 loan.

California statute should require that all subprime loans must both (A) include the cost of hazard insurance and property tax escrows in their ability to repay analysis of a subprime loan the cost of hazard insurance and property tax escrows and (B) establish escrow or impoundment accounts for such taxes and insurance.

5. Establish Lender Liability for Broker Acts and Omissions When Yield Spread Premiums are Charged

Finally, to effectively address subprime abuses, it is important to take a stronger approach to addressing the unfair and deceptive tactics that brokers use to push subprime refinances on borrowers. In today's marketplace, nearly three-quarters of subprime loans are brokered. California's current regulatory approach is complaint-driven and ineffective either in deterring broker malfeasance or in providing remedies to borrowers.

Experts on mortgage financing have long raised concerns about problems inherent in a market dominated by broker originations. For example, Federal Reserve Board Chairman Ben S. Bernanke recently noted that placing significant pricing discretion in the hands of financially motivated mortgage brokers in the sales of mortgage products can be a prescription for trouble, as it can lead to behavior not in compliance with fair lending laws.[15]

Whether the lender directly originates an abusive loan or funds an abusive loan originated by a broker, the borrower suffers injury, and the lender gets the asset. Moreover, lenders, who are mortgage professionals themselves, as well as repeat users of brokers' services, have the expertise, the leverage and the capacity to exercise oversight of the brokers with whom they do business. Consumers do not. The costs of their failure to do so should therefore be borne by lenders, not borrowers

It is appropriate, therefore, to hold the lender responsible for abusive subprime loans, regardless of whether originated by the lender directly, or through the broker. Allowing lenders to obtain

[15] Remarks by Federal Reserve Board Chairman Ben S. Bernanke at the Opportunity Finance Network's Annual Conference, Washington, D.C. (November 1, 2006).

the benefit of broker misconduct without associated liability distorts the market and substantially undermines the effectiveness of any regulations. It would also leave borrowers without adequate remedies. Brokers are commonly thinly capitalized and transitory, leaving no assets for the borrower to recover against. Even more problematic are the hurdles that unclear lender liability creates as borrowers seek to defend foreclosures on the basis of origination improprieties.

This is true for all broker-originated loans and, to be effective, such provision should apply across the board for subprime loans. But there is even greater reason to codify lender liability where the lender pays the broker a yield spread premium. Such payments distort competitive market forces by creating a reverse competition effect – the broker shops for his or her own best deal, not the best deal for the customer. This is particularly insidious, as yield-spread premiums generate a financial conflict of interest in a professional whose primary duty should be to his customer, with the result that consumers pay a higher price than that for which they qualify.[16]

And lenders should not be allowed to use their profitable relationships with brokers as a shield to make abusive loans – lenders cannot simply offload the responsibility to place borrowers in loans they can afford. At a minimum lenders must engage in proper due diligence of the brokers they use and the brokered loans themselves.

The establishment of lender liability for broker acts and omissions is a critical step to clamp down on unfair, deceptive and abusive practices. At a minimum, yield spread premiums should be included in the calculation of what is a high cost loan under California's predatory lending law. This was the legislature's original intent of the law, but was subsequently overturned, erroneously and in conflict with the Department of Real Estate's own legal opinion.[17]

IV. Conclusion

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[16] Theoretically, the yield spread is paid, at the consumer's choosing, to lower closing costs. Empirically, that trade-off has not been found. *See, e.g.* Testimony of Howell E. Jackson, Senate Banking Committee Hearing on "Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums" (January 8, 2002), available at http://banking.senate.gov/02_01hrg/010802/jackson.htm#N_1_ ("Homeowners who are short on cash could, theoretically, use yield spread premiums to finance settlement costs. My study, however, offers compelling evidence that yield spread premiums are not being used in this way."); *See also* Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing* 44 Harvard J. on Leg. 123, note 94 and sources cited therein.

[17] This would require amending definitions of "covered loan" and "points and fees" to explicitly include YSPs in the counted costs of the loan. Cal. Fin. Code §§ 4970(b)(2) & (c)(2). Under current law, one way a consumer loan is deemed a covered loan and therefore receives special protections is if the total points and fees payable by the consumer at or before closing for a mortgage or deed of trust exceed 6 percent of the total loan amount. California's definition of points and fees includes "all compensation and fees paid to mortgage brokers in connection with the loan transaction."

A YSP is a bonus paid by a lender to a mortgage broker when a loan is originated at an interest rate higher than the minimum interest rate the lender approved. In Wolski v. Fremont Investment & Loan, 25 Cal. Rptr. 3d 500 (Cal. Ct. App. 2005), a state appellate court held that a YSP should not be included in the definition of points and fees because the lender, not the consumer, pays a YSP, and because the consumer pays excess interest only after loan closing. The Court in *Wolski* did not take notice of the fact that the California Department of Real Estate has issued a legal opinion on the issue, finding that yield spread premiums were originally intended by the legislature to be included in the points and fees calculation.

Today we are seeing massive disruptions in the financial markets following years of reckless lending on subprime mortgages. This issue has been prominent in the media recently, but the problems are not new. For years, housing analysts and many policymakers have known that most predatory lending occurs in the subprime market, and that subprime loans too often lead to foreclosure rather than sustainable ownership.

The foreclosure crisis has large potential implications for California. Record numbers of borrowers could lose their homes. Declining housing prices could reduce the equity, wealth and spending of homeowners throughout the state. Jobs are already down sharply in the mortgage industry which has been centered in Southern California, but could spread to the home construction sector. And recent turmoil in global credit markets linked to the subprime lending crisis make the prospect of a housing-led recession a real possibility.

While other states have taken action to stem foreclosures and to raise standards on subprime lending, California has yet to enact new provisions. I hope today's hearing marks a turning point where California will take aggressive action to sustain affordable homeownership and restore investor faith in America's subprime mortgage markets.

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